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Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA, PETITIONER

v.

GENERAL DYNAMICS CORPORATION, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

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QUESTION PRESENTED

Whether a taxpayer using the accrual method of tax accounting is entitled to deduct, as a fixed liability at the close of its taxable year, an addition to a reserve for future expenses expected to be paid under an employee medical reimbursement plan, where the addition is based on the taxpayer's estimate of its liability to employees who were assumed to have received medical care during the year, but who had not submitted claims for payment, or whose claims for payment had been submitted but not approved, before the close of the taxable year.

PARTIES TO THE PROCEEDING

In addition to the parties named in the caption, Datagraphix, Inc., Material Service Corporation, Marblehead Lime Corporation, and General Dynamics Land Systems, Inc. (formerly Stromberg-Carlson Corporation), are respondents. Each is a wholly-owned subsidiary of General Dynamics Corporation.

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The Solicitor General, on behalf of the United States, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Federal Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-5a) is reported at 773 F.2d 1224. The opinion of the Claims Court (App. *infra*, 6a-18a) is reported at 6 Cl. Ct. 250.

JURISDICTION

The judgment of the court of appeals (App., *infra*, 20a) was entered on September 19, 1985. On December 9, 1985, the Chief Justice extended the time within which to petition for a writ of certiorari to and including February 16, 1986 (a Sunday preceding a federal legal holiday). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant portions of Sections 162, 446 and 461 of the Internal Revenue Code of 1954 (26 U.S.C.), and of Sections 1.446-1 and 1.461-1 of the Treasury Regulations on Income Tax (26 C.F.R.), are set out in a statutory appendix (App., *infra*, 21a-26a).

STATEMENT

1. For many years respondent General Dynamics Corporation and its subsidiaries have been required by collective bargaining contracts to maintain health insurance coverage for their employees. Under these health plans, employees pay the first $100 of covered charges (generally called "the deductible") before becoming eligible for benefits. After that, employees generally are entitled to reimbursement for 80% of the covered medical costs that they or their dependents incur (C.A. App. 64). Certain items—such as expenses related to pregnancy and childbirth, the costs of footcare and eyeglasses, the costs of "check-up examinations and tests not reasonably necessary to medical treatment"—are not covered by the plans (*id.* at 54, 56). In the case of otherwise-covered items, employees are not entitled to reimbursement if the treatment is for work-related injuries, if the treatment is furnished by an unapproved practitioner, if the expenses are incurred within 30 days of an employee's entry into the plan, or if the expenses are attributable to certain pre-existing conditions (*id.* at 54, 57, 61-62; PX 47, at 41-48, 51-52). The plans specify a maximum amount allowable per illness, a maximum amount allowable for each particular treatment or procedure, and a daily limit on hospital charges (C.A. App. 48-50, 55). The plans also specify that reimbursement will not be made for

expenses in excess of the provider's usual charge for a particular treatment or procedure, or in excess of a stated percentage (generally 85% or 90%) of the customary charge prevailing in the neighborhood (*id.* at 56; PX 47, at 33-36).

To be entitled to reimbursement under respondent's health plans, a covered employee must submit a claim for benefits on a standard form (App., *infra*, 7a). The claim must be accompanied by itemized bills evidencing the amount paid and specifying the diagnosis and treatment given (*id.* at 7a-8a; C.A. App. 58). Respondent has no obligation to make any payment unless and until an employee has submitted a properly-documented claim for benefits and the claim has been determined to qualify for payment under the terms of the plans.

2. Prior to October 1, 1972, respondent supplied the health benefits outlined above by purchasing group medical insurance from two outside carriers, Aetna Life Insurance Company and Prudential Insurance Company. Insurance companies are generally required by state law to maintain certain reserves with respect to the insurance coverage that they provide. In the case of the medical insurance coverage that Aetna and Prudential provided to respondent's employees, both companies prior to October 1, 1972, maintained reserves for health claims that they estimated (1) had arisen, but had not yet been reported to them, or (2) had been reported to them, but had not yet been processed or approved for payment (App., *infra*, 8a). These reserves represented a statistical estimate, based on each carrier's past experience, of the amount that it would ultimately have to pay with respect to such actual or potential claims. Reserves of this sort are usually called "incurred but not reported," or "IBNR," reserves (*ibid.*). Under

the special tax provisions applicable to insurance companies, an insurance company, unlike other taxpayers, is generally permitted to deduct additions to reserves (including IBNR reserves) that are required by state law. See I.R.C. §§ 807 (life insurance companies), 832(b)(5) (casualty insurance companies).

On October 1, 1972, respondent became a self-insurer of its health care plans. Although respondent thus ceased paying premiums to Aetna and Prudential, those companies continued to administer the plans for a fee under service agreements (App., *infra*, 7a). This shift to self-insurance entailed no change in the medical benefits provided to respondent's employees; from their perspective, the only difference was that their health-benefits checks thenceforth were drawn on a different bank. Respondent's shift to self-insurance likewise entailed no change in the claims-processing procedure or in the personnel responsible for implementing it; employees' claims continued to be screened in the first instance by the claims department at respondent's plants, and then to be forwarded to the insurance company for evaluation and approval (*ibid.*).

On the date respondent became a self-insurer, it agreed to pay all health claims that Aetna and Prudential had previously reserved against. On the same day, respondent took an amount equal to the aggregate IBNR reserves that Aetna and Prudential had previously maintained for those claims, and set that amount up as a liability on its own books. On December 31, 1972, using statistics supplied by those companies, respondent calculated an estimate of its liability to employees who were assumed to have received medical care during the last three months of 1972, but who had not submitted claims, or whose

claims had been submitted but not approved, as of that date. The amount thus calculated was added to the beginning IBNR reserve balance that respondent had inherited from the insurance companies. Respondent then calculated the amount that it had actually paid out on approved claims during the final quarter of 1972. That amount was subtracted from the reserve balance. See App., *infra*, 8a-9a; C.A. App. 27-33. These calculations produced a year-end IBNR reserve balance in the amount of $5,575,289, representing respondent's estimate of its anticipated liability to pay benefits on claims arising from pre-1973 medical treatment. App., *infra*, 10a; C.A. App. 34-35.

During 1973 and 1974, respondent actually paid out $4,583,893 in benefits on claims arising from pre-1973 medical treatment (App., *infra*, 16a). This sum was approximately $1 million (or 17.8%) less than the amount that respondent had reserved to pay such claims (*ibid.*). It has been the experience of Aetna and Prudential that about 90% of the amounts for which respondent's employees claim reimbursement are actually approved for payment (*id.* at 12a). As to the balance, the claims are rejected in whole or in part because the expenses for which reimbursement is sought are not covered by the health plans, because a specified maximum charge has been exceeded, because the treatment is not deemed medically necessary, or because the employee's expenditure otherwise fails to qualify for reimbursement under the terms of respondent's plans.

3. Respondent uses the accrual method of accounting for federal tax purposes. On its consolidated federal income tax return for calendar year 1972, respondent originally did not deduct any portion of its IBNR reserve in computing its tax (C.A. App.

34). In 1977, however, after the IRS had commenced an audit of that return, respondent filed an amended return for 1972, claiming that it was entitled to a deduction under Section 162 of the Code[1] in the amount of $5,575,289—the 1972 year-end balance of its IBNR reserve—as an "ordinary and necessary [business] expense[ ] paid or incurred during the taxable year." See C.A. App. 37-38.

The Commissioner denied respondent's claim for refund. He noted that, under the accrual method of tax accounting, an expense may not be deducted until "all of the events have * * * occurred which fix the liability" (Treas. Reg. § 1.461-1(a)(2)). The Commissioner determined that the events which would fix respondent's liability to pay for a particular employee's medical treatment would be that employee's submission of a properly-documented claim for reimbursement, and respondent's determination that the claim qualified for payment, in some future tax year. Until those events occurred, the Commissioner concluded, respondent's obligation to pay was contingent and hence gave rise to no deductible expense.

Following the denial of its administrative claim for refund, respondent filed this refund suit in the Claims Court. That court ruled for respondent (App., *infra*, 6a-18a). It held that the last event necessary to fix respondent's liability to reimburse its employees occurred "when a qualified employee or dependent receive[d] covered medical services" (*id.* at 11a, 13a). In the court's view, an employee's submission of a claim for benefits, and respondent's evaluation of the claim with a view to determining whether or not it

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

qualified for payment, constituted mere "clerical," "administrative," or "ministerial" steps that were not "condition[s] precedent to establishing the fact of liability" (*id. at* 12a). The court held, moreover, that respondent, in order to establish the fact of its liability, was not required to demonstrate "any specific liability to particular employees who received treatment" (*id.* at 9a). Rather, it was sufficient for respondent to "estimate [its] aggregate liability" to its employees as a group, basing its estimate on a statistical probability that a certain quantum of covered medical services had been rendered to covered recipients (*ibid.*). The court noted that respondent's method of computing its IBNR reserve "reflected accepted insurance company practice" and that "insurance companies can and do deduct such reserves" (*ibid.*). The court concluded that respondent was entitled to deduct the entire 1972 year-end balance of its IBNR reserve as a salary expense "incurred during the taxable year" (I.R.C. § 162(a)).

The Federal Circuit affirmed (App., *infra*, 1a-5a). It stated that the issues had been "thoroughly treated in the trial court's opinion" and that the only question "which [it] need[ed] to address on appeal" was whether the decision below was contrary to Court of Claims precedent (*id.* at 1a-2a). The Federal Circuit answered that question in the negative and proceeded to "affirm * * * on the basis of the Claims Court opinion" (*id.* at 5a).

REASONS FOR GRANTING THE PETITION

This case presents an important question of federal tax law. The decision below is squarely at odds with fundamental principles that this Court has enunciated to govern accrual of deductions under the "all events" test of tax accounting, and it conflicts with

the decisions of other courts of appeals that have applied those principles. The decision below produces an irrational result: by permitting respondent to take a current tax deduction for estimated liabilities based solely on extrapolations from past experience, that decision would permit the deduction of expenses that respondent may never incur at all. The question presented here is related to, but has considerably broader implications than, the question now pending before this Court in *United States* v. *Hughes Properties, Inc.*, No. 85-554, also on certiorari to the Federal Circuit. Given the prevalence of employer-sponsored medical reimbursement plans, the revenue impact of the decision below, rendered by a court of nationwide jurisdiction, is substantial. Review by this Court is therefore appropriate.

1. a. Section 162(a) of the Code allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." A taxpayer who uses the "cash receipts and disbursements method" of accounting (I.R.C. § 446(c)(1)) is entitled to deduct business expenses only in the year in which they are paid (Treas. Reg. §§ 1.446-1(c)(1)(i), 1.461-1(a)(1)). A taxpayer who uses the "accrual method" of accounting (I.R.C. § 446(c)(2)), by contrast, is entitled to deduct expenses in the year in which they are "incurred," regardless of when they are actually paid (I.R.C. § 162(a); Treas. Reg. § 1.461-1(a)(2)).

For almost sixty years, the standard for determining when an item of expense is to be regarded as "incurred," and hence as being properly deductible for federal tax purposes, has been the "all events" test. First enunciated by this Court in *United States* v. *Anderson*, 269 U.S. 422, 424 (1926), the test was subsequently incorporated in the Treasury Regula-

tions. It has two elements, both of which must be satisfied before accrual of an expense is proper. First, "all the events [must] have occurred which establish the fact of the liability giving rise to [the] deduction" (Treas. Reg. § 1.446-1(c)(1)(ii)). Second, the amount of the deduction must be able to "be determined with reasonable accuracy" (*ibid.*). While the second part of the test permits a degree of computational flexibility, the Regulations emphasize that the first part of the test is absolute: "no accrual shall be made in any case [unless] all of the events have * * * occurred which fix the liability" (Treas. Reg. § 1.461-1(a)(2)).

In determining whether a liability has become "fixed," and thus constitutes an "expense incurred during the taxable year" for federal tax purposes, this Court long ago made clear that "a liability does not accrue as long as it remains contingent." *Brown* v. *Helvering*, 291 U.S. 193, 200 (1934). "The prudent businessman," Justice Brandeis wrote for the Court, "often sets up reserves to cover contingent liabilities. But they are not allowable as deductions." *Lucas* v. *American Code Co.*, 280 U.S. 445, 452 (1930) (footnote omitted). To be deductible for federal tax purposes, "the obligation to pay [must] ha[ve] become final and definite." *Security Flour Mills Co.* v. *Commissioner*, 321 U.S. 281, 287 (1944). It must be "fixed and absolute." *Brown* v. *Helvering*, 291 U.S. at 201. It must be "unconditional." *Lucas* v. *North Texas Lumber Co.*, 281 U.S. 11, 13 (1930). It must not be "contested by the taxpayer." *Dixie Pine Co.* v. *Commissioner*, 320 U.S. 516, 519 (1944). "[T]he tax law requires," in short, "that a deduction be deferred until 'all the events' have occurred that will make it fixed and certain." *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 543 (1979)

(quoting *United States* v. *Anderson*, 269 U.S. at 441).

b. Contrary to the Claims Court's statement (App., *infra*, 13a), respondent's liability to reimburse its employees for their medical expenses was not "fixed and certain," was plainly not "unconditional" or "absolute," at the close of its 1972 taxable year. Under its collective bargaining contracts, respondent had no obligation to pay any medical benefits unless and until (1) an employee submitted a properly-documented claim for reimbursement and (2) respondent and its agents satisfied themselves that the claim qualified for payment under the terms of the health plans. The obligation represented by respondent's IBNR reserve was contingent at the close of its 1972 tax year because, as to every putative obligee, one or both of those conditions had not been met.

In constructing its IBNR reserve, respondent made an assumption that an indefinite number of its employees had received medical services during 1972. As respondent conceded, however, many of those supposed recipients had not submitted any claim for reimbursement before the year ended. It was entirely possible, moreover, that some of those individuals would never submit a claim at all. Some might regard the medical expenses that they had incurred as too insignificant to warrant the trouble of seeking reimbursement. Some might not wish their employer's agents to know that they had undergone treatment for certain medical conditions. And some might fail to submit claims because of inadvertence or neglect. Since respondent had no obligation to pay medical benefits unless an employee filed a claim therefor, respondent's liability to these potential claimants was neither "unconditional" nor "absolute" at the close of its 1972 tax year.

The balance of the employees in question had submitted claims to respondent, but their claims had not been determined to qualify for payment as of December 31, 1972. As to each claimant in this group, respondent reserved the right to contest its liability to make reimbursement on the grounds (inter alia) that the medical procedure was not covered by the health plans, that stipulated maximum charges had been exceeded, that the treatment was not medically necessary, or that the expenditure otherwise failed to qualify as a "covered medical expense." Although the trial court characterized the claims-processing procedure as "ministerial" and "routine" (App., *infra*, 12a), the court in fact found that only 90% of the amounts claimed by respondent's employees, on average, were actually approved (*id.* at 12a-13a). Since there thus existed a substantial possibility that any particular claim would be denied in whole or in part, respondent's liability to these claimants, like its liability to those employees who had not filed claims at all, was neither "unconditional" nor "absolute" on the last day of 1972.

The trial court sought to avoid this conclusion by reasoning that respondent's liability became "fixed * * * upon occurrence of the insured event—the receipt of covered services by the insureds" (App., *infra*, 15a). But this reasoning merely assumes what respondent was required to prove. Respondent made no attempt to ascertain whether any employee had in fact received medical services, much less that any employee had received *covered* medical services, before the close of its tax year. Obviously, respondent could not have shown that unless it had looked at its employees' claims to see if they qualified, something that respondent by hypothesis had not done. Rather, respondent simply *assumed*, based on projections from past experience, that a certain dollar

volume of covered services had been rendered to an indeterminate number of unknown workers.

Such an assumption is incompetent as a matter of law to "establish the fact of the liability" (Treas. Reg. § 1.446-1(c)(1)(ii)) under this Court's decisions. Those decisions require that a deduction be deferred until *all the events* have occurred that fix the taxpayer's liability *absolutely* and *unconditionally*. An assumption that one has incurred an obligation in an estimatible amount cannot constitute proof of an "unconditional liability" if words are to retain their meaning. Respondent's liability was to pay medical benefits to *individuals* upon their satisfaction of certain conditions precedent. It has long been clear that a liability becomes "fixed" only when it is based on known facts respecting individual claimants; it cannot be based on projections of aggregate liability suggested by past experience. Indeed, the Federal Circuit's predecessor itself held that "[t]he *individual items* must represent fixed liabilities" and that the fact (as opposed to the amount) of liability "cannot be approximated or estimated." *Union Pac. R. Co.* v. *United States*, 524 F.2d 1343, 1351 (1975) (emphasis added; original quotation marks omitted). The burden of proving deductions is on the taxpayer (*Helvering* v. *Taylor*, 293 U.S. 507, 514-515 (1935)), and respondent simply failed to prove that, by this standard, it had become liable to any individual as of the date its tax year closed.

Because respondent did not demonstrate the existence of a fixed and unconditional obligation as of the close of its taxable year, it failed to "establish the fact of [its] liability" (Treas. Reg. § 1.446-1(c)(1)(ii)) as required by the first part of the "all events" test. Under these circumstances, it is immaterial whether the actuarial data supplied by re-

spondent's plan administrators would have enabled it to satisfy the *second* part of the "all events" test, on the theory that the *amount* of its contingent liability, given those statistical projections, could "be determined with reasonable accuracy" (*ibid.*). As this Court's decisions make clear, the two parts of the "all events" test erect discrete and independent requirements, and *both* must be satisfied before a deduction is allowable.[2]

2. In permitting respondent to take a current deduction for a contingent future expense, the decision below also conflicts in fundamental principle with this Court's decisions emphasizing the critical differences between tax and financial accounting. As we have pointed out at greater length in *United States* v. *Hughes Properties, Inc.*, 85-554 U.S. Br. at 21-29,[3] Congress has vested the Commissioner with "broad powers in determining whether accounting methods used by a taxpayer clearly reflect income" (*Commissioner* v. *Hansen*, 360 U.S. 446, 467 (1959)). Congress's decision in that respect owes in part to "the vastly different objectives that financial and tax accounting have." *Thor Power Tool Co.*, 439 U.S. at 542. "The primary goal of financial accounting is to provide useful information to management, share-

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[2] We argued below that respondent's actuarial data in fact did not enable "the amount [of its liability to] be determined with reasonable accuracy" (Treas. Reg. § 1.446-1(c)(1)(ii)) for purposes of the second part of the "all events" test, pointing out in this connection the $1 million differential between the reserve amount that respondent sought to deduct and the sums that it actually paid. See App., *infra*, 16a. Although we believe that the courts below erred in rejecting our argument (*id.* at 5a, 16a-17a), we are not presenting for review here the question of respondent's ability to satisfy the second part of the "all events" test.

[3] We have furnished a copy of that brief to respondent's counsel.

holders, [and] creditors" and "to protect these parties from being misled" (*ibid.*). Financial accounting accordingly "has as its foundation the principle of conservatism, with its corollary that possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income" (*ibid.*; original quotation marks omitted). "[T]he major responsibility of the Internal Revenue Service," by contrast, "is to protect the public fisc," so that "understatement of income is not destined to be its guiding light" (*ibid.*). Given this diversity, even contrariety, of objectives, to say that a taxpayer's accounting practice " 'is in accord with generally accepted commercial accounting principles' * * * is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury." *American Automobile Ass'n* v. *United States*, 367 U.S. 687, 693 (1961) (footnote omitted).

This Court's cases demonstrate that divergence between tax and financial accounting is especially common where, as here, "a taxpayer seeks a current deduction for estimated future expenses or losses" (*Thor Power Tool Co.*, 439 U.S. at 541). Financial accounting rules, implementing the principle of conservatism, "typically require that a liability be accrued as soon as it can reasonably be estimated" (*id.* at 543 & n.20 (citing authorities)). Accruals of such anticipated liabilities are commonly made by establishing on the corporation's books a reserve account to cover amounts reasonably expected to be paid in the future. See, *e.g.*, *Commissioner* v. *Hansen*, 360 U.S. at 448 (reserve to cover contingent liability in event of nonperformance of guarantee); *Brown* v. *Helvering*, 291 U.S. at 196-197 (reserve to cover expected liability in event of insurance policy cancellations); *Lucas* v. *American Code Co.*, 280 U.S. at 447 (re-

serve to cover contingent liability on contested lawsuit).

"Only a few reserves voluntarily established as a matter of conservative accounting," however, "are authorized by the Revenue Acts." *Brown* v. *Helvering*, 291 U.S. at 201-202. Among the reserves so authorized are those maintained by insurance companies. Congress for many years has provided that insurance companies generally may claim current tax deductions for specified additions to their reserves. See I.R.C. §§ 807 (life insurance companies), 832(b)(5) (casualty insurance companies). Consistently with that statutory authorization, the insurance companies from which respondent bought insurance prior to October 1, 1972, presumably deducted their year-end additions to their IBNR reserves, and those deductions were presumably allowed. See App., *infra*, 8a. Respondent, however, is not an "insurance company," a term that is defined with great precision in the Code. See I.R.C. §§ 816, 831. Respondent had no license, simply by electing to become a self-insurer, and by establishing on its books the same IBNR reserve previously used by Prudential and Aetna, to claim a deduction to which insurance companies alone are entitled.

Contrary to the Claims Court's reasoning, therefore, it is irrelevant that respondent's method of computing its IBNR reserve "reflected accepted insurance company practice" and that "insurance companies can and do deduct such reserves" (App., *infra*, 9a). The propriety of respondent's deduction must be judged, not by principles applicable to insurance companies, but by the "all events" test applicable to taxpayers generally. That test "is designed to assure that taxpayers will not obtain deductions for expenditures that might never occur," and it thus "seeks certainty of liability rather than probability."

World Airways, Inc. v. *Commissioner*, 62 T.C. 786, 805 (1974), aff'd, 564 F.2d 886 (9th Cir. 1977) (citing *Brown* v. *Helvering*, 291 U.S. at 201)).

The courts below ignored these precepts in sustaining respondent's deduction. There was surely a probability that many of respondent's employees who had visited a doctor or hospital during 1972 would subsequently file claims for reimbursement. And there was likewise a probability—apparently in the range of 90%—that those claims, if submitted, would be determined to qualify for payment. Thus, "the principle of conservatism" (*Thor Power Tool Co.*, 439 U.S. at 542) may have required respondent to set up a reserve for those items at once and show them as a liability on its books. "[B]ut the accountant's conservatism cannot bind the Commissioner in his efforts to collect taxes" (*id.* at 543). Although "estimates, probabilities, and reasonable certainties * * * may be useful, even essential, in giving shareholders and creditors an accurate picture of a firm's overall financial health," the tax law, "with its mandate to preserve the revenue, can give no quarter to uncertainty" (*ibid.*). The tax law requires that a taxpayer establish his liability as an unconditional fact, and respondent failed to do so.

As this Court noted in *American Automobile Ass'n*, 367 U.S. at 694-697, Congress once adopted, albeit only briefly, provisions that would have permitted taxpayers to deduct anticipated expenses by a reserve mechanism identical to that used by respondent. As originally enacted in 1954, Section 462 of the Code allowed a deduction for "a reasonable addition to [a] reserve for estimated expenses," with "estimated expenses" being defined to include deductions "attributable to the income of the taxable year or prior taxable years." Internal Revenue Code of 1954, ch. 736, § 462(a) and (d)(1)(B), 68A Stat. 158-159. Sec-

tion 462 was designed to bring "[t]ax accounting more nearly in line with accepted business accounting * * * by allowing reserves to be established for known future expenses." S. Rep. 372, 84th Cong., 1st Sess. 3 (1955). Congress explained that Section 462 would allow taxpayers to deduct estimated amounts of "certain liabilities for self-insured injury and damage claims," precisely the types of claims at issue here. See H.R. Rep. 1337, 83d Cong., 2d Sess. A163 (1954); S. Rep. 1622, 83d Cong., 2d Sess. 63, 305-307 (1954).

The change brought about by Section 462 was short-lived. Congress repealed that provision retroactively less than one year later, prompted by warnings from the Treasury Department "that the proposed endorsement of such [methods of] accounting would have a disastrous impact on the Government's revenue." *American Automobile Ass'n*, 367 U.S. at 695. The taxpayer in *American Automobile Ass'n* contended that Congress's retroactive repeal of this provision should not be interpreted to preclude use of the reserve method of tax accounting that it employed, but the Court held that this contention "'varnish[ed] nonsense with the charm of sound'" (367 U.S. at 695). "[T]he cold fact," the Court said, "is that [Congress] repealed the only law incontestably permitting the practice upon which the [taxpayer] depends" (*ibid.*).

Congress thus has specifically considered and, upon reconsideration, rescinded a provision that would have achieved the very result that the court of appeals here adopted. That court had no license, by misapplying the "all events" test, to resurrect the rule that Congress deliberately discarded.

3. The decision below also conflicts, either directly or in fundamental principle, with numerous appellate

decisions that have denied deductions in circumstances substantially similar to those here. It often happens that a taxpayer is under a present obligation —be it statutory, regulatory, or contractual—to make specified future payments upon the happening of specified future events. Relying on decisions like *Brown* v. *Helvering*, *supra*, the lower courts have held that such generalized and incomplete obligations cannot justify current tax deductions under the "all events" test, correctly reasoning that such liabilities remain contingent until the requisite future events have transpired.

In *Trinity Construction Co.* v. *United States*, 424 F.2d 302 (5th Cir. 1970), for example, an employer had a contractual obligation to pay future premiums on policies insuring the lives of key employees, and it sought a current deduction for the premium payments expected to be made over the contract term. The Fifth Circuit denied a deduction; it noted that the employer's liability was contingent on the employees' being alive when the premiums were due, and it held that an expense may be deducted "only in the taxable year when the obligation to pay it is unconditionally fixed" (424 F.2d at 305). In *Bennett Paper Corp.* v. *Commissioner*, 699 F.2d 450 (8th Cir. 1983), an employer had a contractual obligation to make future payments to a profit-sharing plan on account of employees' past services, provided that the individuals were still employed when the payments were due. The Eighth Circuit denied a current deduction; it noted that "the forfeiture provision made the * * * liability a contingent liability," and it held that a "liability is not fixed until all the conditions for payment are met" (699 F.2d at 453). In *World Airways, Inc.* v. *Commissioner*, *supra*, an airline had a contractual obligation to make future pay-

ments for statutorily-required engine overhauls, and it sought a current deduction for amounts expected to be paid over the contract term. The Tax Court denied a deduction; it noted that the taxpayer "was under no obligation to make any payment unless an overhaul was actually performed," and it held that an expense is not deductible unless the taxpayer's liability is "absolutely fixed in the year of accrual" (62 T.C. at 802, 804).

The rationale of these cases shows the error of the holding below. Respondent had a contractual obligation under its collective bargaining agreements to reimburse employees for their medical expenses upon their satisfaction of certain conditions. The employees were required to submit a claim for benefits; they were required to document their claims with itemized bills; and they were required to satisfy respondent that the expenses they had incurred qualified for reimbursement under the terms of the health plans. Respondent had no obligation to make a payment to anyone until those conditions had been met, and, in the case of the amounts reflected in respondent's IBNR reserve, one or more of those conditions had not been met as of December 31, 1972.

4. The question presented here is of great importance to the administration of the revenue laws. The Internal Revenue Service advises that there are currently pending administratively 57 cases that involve the deductibility of IBNR reserves by corporations having self-insured medical reimbursement plans. Approximately $113 million in taxes is involved in those cases alone. The importance of the question, moreover, is not limited to cases involving medical plans, but extends to cases involving any sort of self-insured liability, from an employer's liability under a workers' compensation statute to a shipper's liability

under a contract of carriage. Indeed, in repealing Section 462 thirty years ago, Congress was motivated largely by a Treasury Department estimate that the use of reserve methods of accounting for tax purposes would produce a transitional revenue loss in excess of $1 billion. See *American Automobile Ass'n*, 367 U.S. at 697 n.12; H.R. Rep. 293, 84th Cong., 1st Sess. 3 (1955). That figure would doubtless be a good bit higher today.

As we have noted, the question presented here is related to that now pending before the Court in *United States* v. *Hughes Properties, Inc.*, No. 85-554, which also involves the proper timing of deductions under the "all events" test. The question there is whether a gambling casino using the accrual method of tax accounting is entitled to deduct, as a fixed liability at the close of its taxable year, the amounts registered on the "jackpot indicators" of its progressive slot machines, even though it has no obligation to pay such amounts unless and until the jackpots are won by its patrons in some future year. Although the instant case raises a similar legal issue, it presents a question of substantially broader implications, involving as it does the ability of taxpayers to deduct mere estimates of liability based on projections from past experience. Given the prevalence of self-insurance plans among this country's major corporations, moreover, the factual setting of the instant case is far more typical of the problems that confront the Commissioner and taxpayers alike in this difficult area of the law. The Court's decision in *Hughes Properties* will not necessarily be dispositive of the outcome here, and we believe that this case warrants the Court's plenary review.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

CHARLES FRIED
Solicitor General

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FEBRUARY 1986

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

No. 85-760

GENERAL DYNAMICS CORP., ET AL., APPELLEES

v.

THE UNITED STATES, APPELLANT

DECIDED: September 19, 1985

Before FRIEDMAN, RICH, and BISSELL, *Circuit Judges.*

BISSELL, *Circuit Judge.*

The United States (government) appeals from the judgment of the United States Claims Court, entered on September 10, 1984, granting General Dynamics Corp. and its subsidiaries (taxpayer) a refund of federal income taxes of $31,708 (plus interest). We affirm.

OPINION

The issues presented in this court, with one exception, were thoroughly treated in the trial court's opinion filed by Judge Seto, reported at 6 Cl. Ct. 250 (1984). The one issue which we need to address on

appeal is the government's contention that the Claims Court's application of the "all events test" in Treas. Reg. § 1.461-1(a)(2) (1984) is contrary to precedent binding upon this court.[1]

Taxpayer, an accrual basis taxpayer, is a self-insurer of its medical care plan. It deducted, as an expense on its federal income tax return, an estimate of its liability to pay for medical care for employees who had obtained treatment but whose claims had either not yet been filed or had not been processed at the end of the taxable year in issue. The Claims Court found that taxpayer's claimed deduction met the "all events" test for deduction of an expense by an accrual basis taxpayer. An accrual basis taxpayer is entitled to deduct an expense in the taxable year in which *all the events have occurred* to establish *the fact* of the liability for the expense and fix *the amount* thereof with reasonable accuracy. Treas. Reg. § 1.461-1(a)(2) (1984).

The government argues that even though the Claims Court decision may be supported by the law of another circuit, *Kaiser Steel Corp. v. United States*, 717 F.2d 1304 (9th Cir. 1983), it is in conflict with the law of this circuit as expressed in *Eastman Kodak Co. v. United States*, 534 F.2d 252 (Ct. Cl. 1976). We believe the government's interpretation of *Eastman Kodak* is unwarranted. When one reads *Eastman Kodak* in conjunction with *Washington Post Company v. United States*, 405 F.2d 1279 (Ct. Cl. 1969), and *Inland Steel Company v. United States*, 212 Ct. Cl. 558 (1976), one understands that an

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[1] In *South Corp. v. United States*, 690 F.2d 1368 (1982), this court adopted the Court of Claims precedent as binding upon it.

affirmance of the trial court's judgment is not contrary to the law in this circuit.[2]

With regard to the first prong of the "all events test," the government emphasizes that it is the law in this circuit "that the *fact of liability* is measured on an item by item basis, rather than as an overall estimate." *Eastman Kodak*, 534 F.2d at 258 (emphasis in original). Since taxpayer failed to determine the fact of its liability on an employee by employee basis, the government's position is that *Eastman Kodak* requires reversal of the trial court.

The statement extracted by the government from that opinion, in context, related to the analysis as to whether for each employee the fact of liability is certain and not subject to future events. In the case at bar the Claims Court held that the last event necessary to fix the fact of liability was the occurrence of the insured event, the receipt of covered medical services. As the court explained, taxpayer was "not predicting the happening of future events: rather, [it was] estimating the amount of fixed liability for events which had already occurred." 6 Cl. Ct. at 255. That result is not contrary to *Eastman Kodak* which required that "Kodak must show that the fact of payroll tax expense for the given employee was *certain for each employee* as of the end of [the tax year]." 534 F.2d at 258-59 (emphasis in original). The complicating feature of the payroll tax which

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[2] Counsel for the government, although aware that a panel of this court is bound by prior precedential decisions unless and until overturned *in banc*, overlooks the fact that "statements in opinions of this court must be read harmoniously with prior precedent, not in isolation." *Kimberly-Clark Corporation v. Fort Howard Paper Company*, No. 85-902, slip op. at 6 (Fed. Cir. Sept. 6, 1985).

the *Eastman Kodak* court addresed was the yearly ceiling on the tax. "The effect of the ceiling is to create a degree of uncertainty in determining, as of the end of a given year, at what time or for how many months an employer will have to pay tax during the next year for each individual employee." 534 F.2d at 259. The ceiling created uncertainties as to the payroll tax on bonuses and vacation pay because events in the subsequent year, an intervening pay raise and the timing of a vacation, would affect the fact of liability. That situation does not obtain here for there were no events in the subsequent year which would alter the fact of liability. Just as the taxpayer in *Inland Steel* became committed to ultimately pay the prescribed amount of liability as hourly services were rendered by employees during the taxable year, 212 Ct. Cl. 560, so the taxpayer here became committed to pay prescribed amounts of liability as covered medical services were received by each employee during the taxable year.

With regard to the second prong, the government argues that *Eastman Kodak* requires that the reasonable accuracy of the amount deducted be based on each claim, reminding us that "[t]he test must be applied to each employee on an individual basis." *Eastman Kodak*, 534 F.2d at 261. Since taxpayer failed to calculate the amount of its liability on an employee by employee basis, the government's position again is that *Eastman Kodak* requires reversal. Again the government's interpretation of *Eastman Kodak* is unwarranted. The second prong of the test is whether the amount of liability "is reasonably *ascertainable* for each employee." *Eastman Kodak*, 534 F.2d at 261 (emphasis added). *Eastman Kodak* did not hold that the amount of liability must be

actually *ascertained*. The trial court in this case properly rejected the necessity for actual ascertainment on an employee by employee basis where in a situation such as this a canvass of taxpayer's 56,000 employees was theoretically possible, but obviously would have been prohibitively expensive and overly burdensome.

In the light of the foregoing, we believe the judgment of the Claims Court is not contrary to our precedent. Accordingly, we affirm that judgment on the basis of the Claims Court opinion.

Affirmed.

APPENDIX B

IN THE UNITED STATES CLAIMS COURT

No. 7-81T

GENERAL DYNAMICS CORPORATION, ET AL.

v.

THE UNITED STATES

(Filed: September 7, 1984)

OPINION

SETO, *Judge.*

In this action, plaintiffs request an income tax refund based on an accrued expense deduction which was disallowed by the Internal Revenue Service for the taxable year 1972. The issue before the court is whether the fact and amount of plaintiffs' liability is certain enough for the purpose of determining an accrued expense deduction. For the reasons set forth below, the court concludes that the deduction should be allowed and that plaintiffs are entitled to a refund.

FACTS

A three-day trial was held in St. Louis, Missouri where plaintiffs introduced the testimony of various expert witnesses, along with an extensive stipulation of facts. Defendant accepted the majority of plaintiffs' factual assertions, but disputed plaintiffs' claims as a matter of law.

Stromberg-Carlson Corporation, DatagraphiX Inc., Material Service Corporation, Marblehead Lime Co., Freeman Coal Corporation, and United Electric Coal Companies (hereinafter "plaintiffs") are, and were in 1972, wholly-owned subsidiaries of General Dynamics Corporation, a Delaware corporation with its principal office in St. Louis, Missouri. In 1972, plaintiffs used an accrual method of accounting with a fiscal year coinciding with the calendar year.

From 1962 until October 1, 1972, plaintiffs purchased group medical insurance from Aetna Life Insurance Company ("Aetna") for some of plaintiffs' offices and from Prudential Insurance Company of America ("Prudential") for other offices. This insurance included medical care benefit plans for plaintiffs' employees and their qualified dependents. In the last quarter of 1972, plaintiffs became self-insurers for their medical care plans. Aetna and Prudential continued to work with plaintiffs under separate Administrative Services Agreements, whereby the insurance companies administered the self-insured plans for the locations that each insurance company had previously insured for plaintiffs. There were no changes in medical benefits provided or in the personnel who were handling the claims-processing procedure.

The claims-processing procedure was straightforward. When an employee or qualified dependent received medical treatment covered by the plan, the employee obtained payment for the treatment by submitting a health-expense benefits claim form to plaintiffs' employee-benefits personnel office at the appropriate facility. The claim form contained pertinent information about the employee and the treatment, including the date and cost of each medical service. Claim forms, with itemized bills attached, were

checked against personnel records to verify that the persons making the claims were eligible under the plan at the time of treatment. Eligible claims were sent to Aetna or Prudential, depending on the facility of origin, for final processing and payment. Drafts were issued either on plaintiffs' account or from one of the insurance companies' accounts pursuant to an automatic funds-transfer arrangement with plaintiffs.

The period between the rendering of medical services and the payment for such treatment was labeled a "lag time" by plaintiffs. For example, on December 31, 1972, plaintiffs had neither received all of the claim forms which would be filed for medical services rendered in 1972, nor completely processed all filed claims. Consequently, plaintiffs established reserve accounts to reflect their liability for medical care received during the last quarter of the calendar year 1972, but unpaid as of December 31, 1972. As accrual-basis taxpayers, plaintiffs deducted expenses not when actually paid, but rather in the taxable year in which they were incurred. The reserves were substantially similar to those established by Aetna and Prudential to reflect their accrued liability for incurred but not yet reported claims ("IBNR" reserves). Prior to October 1, 1972, Aetna and Prudential deducted their IBNR reserves in the taxable year the services were received. Plaintiffs sought advice from Aetna and Prudential concerning accurate estimation of liability for medical care benefits. They were advised that the liability for unpaid benefits could be reasonably determined as a percentage of the payments for medical benefits actually made during a prior period of equal length. The percentage figure was based upon an analysis of plaintiffs' ex-

perience with lag between accrual and payment of claims.[1]

Plaintiffs' method of computing their reserves did not reflect any specific liability to particular employees who received treatment; rather, plaintiffs estimated their aggregate liability. While plaintiffs admit that it would have been theoretically possible to canvass their employees in an effort to determine the approximate amount of their liability, as of December 31, 1972, such a procedure would have been prohibitively expensive and overly burdensome. Thus, plaintiffs used what they claim was the most reasonable method for estimating their liability in the aggregate—a method derived from procedures developed by the insurance companies. *See* note 1. Plaintiffs' evidence that its methods reflected accepted insurance company practice was essentially uncontested. Defendant did not dispute the accuracy of these practices or that insurance companies can and do deduct such reserves.

Plaintiffs used the above-mentioned methods to determine that, as of the end of 1972, their liability

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[1] Accruals for Prudential plans were established using a "lag factor" derived by averaging both the number of days of lag for each claim and the amount of each payment. This lag factor was then applied to the total amount of claims paid in the prior period. The Aetna-serviced facilities determined their reserves by (1) taking the reserve balances returned upon the change to self-insurance; (2) adding a monthly provision for additional medical benefits; and (3) subtracting the medical benefit drafts which had been paid by year end. Aetna had developed lag factors based on plaintiffs' specific experience which, when compared to the standard lag factor, revealed a close correlation. As a result, plaintiffs used a standard lag factor derived from Aetna's actuarial studies, adjusted both for inflation and for application to the amount of claims paid in a three-month period.

for medical care received during the last quarter of 1972 was $5,575,289. This amount was carried as a liability on plaintiffs' financial statement as of December 31, 1972. General Dynamics Corporation, on behalf of its subsidiaries, filed a consolidated federal income tax return for the calendar year 1972. Plaintiffs did not deduct the reserves in that year; instead, they filed a claim in 1973 [*sic*] asking for the 1972 accrued expense deduction and a refund of $31,708 plus interest. The deduction was disallowed by the Internal Revenue Service.

DISCUSSION

The issue before the court is whether plaintiffs may properly deduct their employee medical benefit reserves in 1972 in accordance with their accrual method of accounting and the Internal Revenue Code.

There is no dispute that expenses incurred by plaintiffs in connection with the medical benefit plans were deductible as ordinary and necessary business expenses under Section 162(a) of the Internal Revenue Code, Title 26 of the United States Code (hereinafter "the Code"). The issue is the timing of plaintiffs' deduction. The general rule establishing the proper taxable year for taking such deductions for accrual method taxpayers is set forth in Treasury Regulation Section 1.461-1(a)(2): "The taxable year in which *all the events have occurred* which determine *the fact* of the liability[,] and *the amount* thereof can be determined with reasonable accuracy." (Emphasis supplied.) This regulation is an adoption of the "all events" test first formulated by the Supreme Court in *United States v. Anderson*, 269 U.S. 422, 46 S.Ct. 131, 70 L.Ed. 347 (1926). If a taxpayer's liability meets the conditions stated by this test, the deduction must be allowed in accordance with the intent of the

regulation and with the fundamental accounting principle that accrual accounts immediately reflect expenses incurred without regard to the timing of actual payment. *See Dixie Pine Products Co. v. Commissioner*, 320 U.S. 516, 519, 64 S.Ct. 364, 365, 88 L.Ed. 270, 272 (1944) ("a taxpayer who accounts on the accrual basis may, and should, deduct . . . a liability which really accrues in the taxable year.").

Thus, under the "all events" test, the cardinal issue before this court is: By the end of 1972, had all events occurred which established (1) the fact of, and (2) the amount of, plaintiffs' liability for medical treatment received by their employees in 1972?

Fact of Liability

The first prong of the "all events" test requires the taxpayer, seeking to deduct an accrued expense, to demonstrate that the fact of liability was certain at the end of the tax year in question. *Eastman Kodak Company v. United States*, 209 Ct. Cl. 365, 375, 534 F.2d 252, 258 (1976). Plaintiffs assert that their liability is established when a qualified employee or dependent receives covered medical services. At that point, all conditions to basic liability under the self-insured plans are satisfied: (1) the person is eligible for benefits; (2) the services are covered by the plan; and (3) treatment is in fact received. Defendant rejoins that liability is established only after a claim has been received, reviewed, and acted upon by plaintiffs. Defendant avers that until liability is determined by the claims processsor, plaintiffs' obligation to pay benefits is uncertain and therefore, contingent.

The court believes that defendant's emphasis on the claims-processing procedure is misplaced. According to the evidence adduced at trial, the procedure

was routine and clerical. The claims-review process was performed by experienced claims-handling personnel and was a matter of established procedure which included calculating the amount of payment according to clear and objective benefit schedules and formulas set forth in the plans. While the claims-processing procedure is a necessary event in obtaining reimbursement under the plans, it is an administrative step of the type considered by the Supreme Court in *Anderson* not to be a bar to satisfying the first prong of the "all events" test. In *Anderson*, where liability for a munitions tax had already accrued, the event of actual tax assessment in the following year was considered to be "technical" and therefore not necessary to satisfy the "all events" test for the deduction of a tax liability reserve. *Anderson*, 269 U.S. at 441. In the instant case, the events of claim filing and processing similarly are ministerial in nature. As a result, they are not a condition precedent to establishing the fact of liability.

While claims are processed to pay all amounts due under the plans, however, the full amount requested in the claims is not always paid. In such cases, the expense is either of the type expressly excluded or only partially covered by plaintiffs' plan. It has been the experience of the administrators of the final processing that approximately 90% of all submitted claims are paid. Defendant asserts that this 10% variance renders the claims-processing procedure adversarial, and the fact of liability therefore contingent. Contingency, however, connotes contest or uncertainty, neither of which is true in plaintiffs' case. There is little question as to the type and the amount of benefits to which the employees are entitled under the plans. Indeed, plan coverage is clearly

outlined in booklets describing the standards for payment. The fact that 10% of the claims include expenses not covered by the plans does not *ipso facto* make plaintiffs' liability uncertain. To the contrary, such liability is fixed and certain at the time the eligible employee receives covered medical care.

Defendant also maintains that, to the extent an injured employee chooses not to file a claim, or is not eligible for claimed benefits, plaintiffs' liability remains uncertain until after a liability determination is made. These types of uncertainties, however, were not considered to render an employer's liability for worker's compensation benefits contingent in *Kaiser Steel Corp. v. United States*, 717 F.2d 1304 (9th Cir. 1983). Following *Crescent Wharf & Warehouse Co. v. Commissioner*, 518 F.2d 772 (9th Cir. 1975), the court in *Kaiser* held that, under a state worker's compensation statute, once a worker is injured in the course of employment and liability is not contested by the employer, all events establishing the self-insured employer's liability to pay have occurred, thus meeting the first prong of the "all events" test. In the present action, plaintiffs' obligation to pay for medical care arose under the self-insured plans when an eligible employee received covered treatment. Indeed, liability was fixed by contract upon receipt of covered medical services. The logic of *Crescent* and *Kaiser* dictates that the fact of *injury* establishes the fact of *liability*. Therefore, the occurrence of the insured event, i.e. an employee receiving covered medical care, is the critical event giving rise to plaintiffs' obligation to pay. For these reasons, plaintiffs' liability cannot be characterized as contingent.

When plaintiffs calculated their liability and deposited the calculated amount in their accrued ex-

pense reserves, those amounts inured to, and for, the benefit of employees who had received medical care in the last quarter of 1972. Defendant would have the court distinguish plaintiffs' reserves from other types of deductible accrued expense reserves, on the basis of the revocability of funds contributed to such accounts. Thus, defendant argues that because plaintiffs were not irrevocably bound to pay the full amount in the reserves, they are attempting to deduct an estimate of future indebtedness. Defendant cites two cases for the proposition that express provisions to contribute certain irrevocably committed amounts to the deductible liability reserves must appear in the plans under which liability was fixed: *Washington Post Company v. United States*, 186 Ct. Cl. 528, 405 F.2d 1279 (1969) (involving a profit-sharing plan), and *Inland Steel Company v. United States*, 212 Ct. Cl. 558, 566 F.2d 1188 (1976) (concerning supplemental unemployment benefits pursuant to a collective bargaining agreement). Both of these cases are unpersuasive. In *Zwicker Knitting Mills v. United States*, 80-2 U.S.T.C. p. 9832 (Ct. Cl. 1980), the Court of Claims held that it is not the presence of such an express provision in a benefit plan which absolutely fixes liability. Moreover, it held that the fact that unexpended portions of the reserve could have conceivably reverted to corporate use is insignificant. *Id.* Finally, it is clear that only the existence of an absolute liability is necessary for passing the "all events" test; absolute certainty that it will be discharged by payment is not. *Helvering v. Russian Finance Construction Corp.*, 77 F.2d 324, 327 (2d Cir. 1935).

Defendant additionally contends that liability wasn't fixed in 1972 because plaintiffs did not know by year's end the identity of the employees who had

received medical treatment that year. Although plaintiffs' situation is distinguishable from the situation in *Kaiser*, wherein taxpayers had the benefit of a filed claim upon which to base their estimated liability, the distinction is immaterial. Plaintiffs' liability, in the instant case, was not based on the filing of a claim; rather, it was fixed under the terms of the self-insured plans upon occurrence of the insured event—the receipt of covered services by the insureds. Temporary uncertainty as to the identity of the payee, or the time or amount of payment, does not preclude a taxpayer from having a fixed liability for purposes of the "all events" test. Once liability itself is fixed, other uncertainties do not destroy the initial certainty. *See Washington Post Company*, 186 Ct. Cl. at 536, 405 F.2d at 1284.

We find that the last event necessary to fix plaintiffs' liability was the *occurrence* of the insured event. Plaintiffs were not predicting the happening of future events; rather, they were estimating the amount of fixed liability for events which had already occurred. As of year end 1972, the events giving rise to plaintiffs' obligation had occurred, and nothing could change the extent of their liability. Applying the "all events" test to the facts of this case in a reasonable and practical manner demonstrates that plaintiffs satisfy the first prong of the test.[2]

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[2] Plaintiffs do not attempt to deduct their reserves under the sections of the Code applicable to insurance companies. Defendant asserts that the existence of these code sections [§§ 809(d)(1) and 832(b)(5) allowing life and casualty insurers to deduct incurred but unascertained losses] and the repeal of § 462 (a section which had allowed ordinary taxpayers to deduct estimated expense reserves) manifest a clear legislative intent against allowing ordinary taxpayers to accrue and deduct estimated expenses. The court disagrees

Amount of Liability

Although the exact amount of plaintiffs' incurred liability could not have been determined by year end, plaintiffs should have been permitted to accrue such liability in 1972, so long as the amount could be computed with reasonable accuracy. Treasury Regulation § 1.461-1(a)(2) (1984). The cardinal issue is whether the amount of plaintiffs' liability for employees who received medical care in 1972, but which benefits became payable in later years, could be determined with reasonable accuracy through application of plaintiffs' methods.

A comparison of the total amount of medical benefit claims paid in 1973 and 1974 for services received in 1972 ($4,583,893), and the accrued reserve amount sought to be deducted for this liability at year-end 1972 ($5,575,289), indicates that 82.2% of the reserve was subsequently paid. This percentage, i.e., 82.2%, is well within the reasonably accurate range accepted by the courts for the purposes of satisfying the second prong of the "all events" test. *See, e.g., Harrold v. Commissioner* 192 F.2d 1002, 1003 (4th Cir. 1951) (81%), and *Denise Coal Company v. Commissioner*, 271 F.2d 930, 936 (3rd Cir. (48%).

Plaintiffs' witnesses from Prudential and Aetna, accepted by the court to be experts in the field of setting and determining reserves under group medical benefit plans, testified that the methods used by

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with this interpretation of legislative history. We think that the 1954 enactment and 1955 repeal of § 462 operates to reestablish the "all events" test as the appropriate standard for ordinary taxpayers to meet. *See American Automobile Association v. United States*, 367 U.S. 687, 698, 81 S.Ct. 1727, 1733, 6 L.Ed.2d 1109, 1116 (1961) (Stewart, J., dissenting).

plaintiffs were reasonably accurate methods for determining the amount of plaintiffs' liabilities for medical services rendered, but not paid, by December 31, 1972. Defendant, however, claims that the accuracy of plaintiffs' liability reserve should not be measured in the aggregate. Defendant asserts that the "all events" test requires an item-by-item approach to determine individual liability as to each employee. The use of the aggregate method for setting amounts of liability reserves, however, was approved by the court in *Kaiser*, 717 F.2d at 1309. Similarly, no separate liability determination as to individuals was required in *Washington Post*, 186 Ct. Cl. at 535, 405 F.2d at 1283. In 1972, plaintiffs employed approximately 56,000 people, and received thousands of claims for payment of medical services rendered in that year. Requiring plaintiffs to determine the amount of liability on an individual basis would be neither realistic nor in accordance with sound business practice. *See Harrold*, 192 F.2d at 1006. Therefore, we find that plaintiffs' system for determining the *amount* of their liability was logical and reasonable.

CONCLUSION

When all the facts which determine the existence of a taxpayer's liability have occurred in the taxable year, and the amount, although not definitely ascertained, is susceptible to reasonably accurate estimation at the end of that taxable year, a deduction from income may be taken. *Harrold*, 192 F.2d at 1006. Because plaintiffs have established that their liability had arisen by the end of 1972, and that their method of calculating that liability is reasonably accurate, the requested deduction will be allowed pursuant to 26 U.S.C.A. § 162(a) n.21 (1978). Having met the

"all events" test, plaintiffs' are entitled to a refund in the amount of $31,708 plus interest, representing their valid deduction for expenses incurred in 1972. Pursuant to RUSCC 58, the Clerk of the Court is directed to enter judgment in accordance with this opinion.

It is so ORDERED.

/s/ ROBERT M. M. SETO
Judge

APPENDIX C

IN THE UNITED STATES CLAIMS COURT

No. 7-81 T

GENERAL DYNAMICS CORP., a Delaware corp.,
STROMBERG-CARLSON CORP., a Delaware corp.,
DATAGRAPHIX, INC., a Delaware corp.,
MATERIAL SERVICE CORP., a Delaware corp.,
and MARBLEHEAD LIME CO., a Delaware corp.

v.

THE UNITED STATES

Filed Sept. 16, 1984

JUDGMENT

Pursuant to the opinion of September 7, 1984, it was held that plaintiffs are entitled to recover.

IT IS ORDERED AND ADJUDGED this date, pursuant to Rule 58, that plaintiffs recover of and from the United States the sum of $31,708 plus interest, representing their valid deduction for expenses incurred in 1972.

FRANK T. PEARTREE
Clerk of Court

By: /s/ Lind A. Eddins
Deputy Clerk

NOTE: As to appeal, 60 days from this date, see FRAP 4(a)

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

No. 85-760
7-81 T

GENERAL DYNAMICS CORP., ET AL., APPELLEES

vs.

THE UNITED STATES, APPELLANTS

JUDGMENT

ON APPEAL from the United States Claims Court.

This CAUSE having been heard and considered, it is

ORDERED and ADJUDGED: Affirmed.
Dated: September 19, 1985

ENTERED BY ORDER OF THE COURT
FRANCIS X. GINDHART,
Clerk

/s/ Francis X. Gindhart
Clerk

Issued as a Mandate: October 11, 1985

APPENDIX E

Internal Revenue Code of 1954 (26 U.S.C.), as amended and as in effect for the years at issue:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *

* * * * * *

SEC. 446. GENERAL RULE FOR METHOD OF ACCOUNTING.

(a) *General Rule.*—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) *Exceptions.*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

(c) *Permissible Methods.*—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

* * * * *

SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) *General Rule.*—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.446-1. *General rule for methods of accounting.*

(a) *General rule.* (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net op-

erating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

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(c) *Permissible methods* — (1) *In general.* Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

(i) *Cash receipts and disbursements method.* Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income

(whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. For rules relating to constructive receipt, see § 1.451-2. For treatment of an expenditure attributable to more than one taxable year, see section 461(a) and paragraph (a)(1) of § 1.461-1.

(ii) *Accrual method.* Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations. For example, a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books.

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§ 1.461-1 *General rule for taxable year of deduction.*

(a) *General rule.*—

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(2) *Taxpayer using an accrual method.* —Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. In the case of certain contested liabilities in respect of which a taxpayer transfers money or other property to provide for the satisfaction of the contested liability, see § 1.461-2. Where a deduction is properly accrued on the basis

of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

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